DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92037

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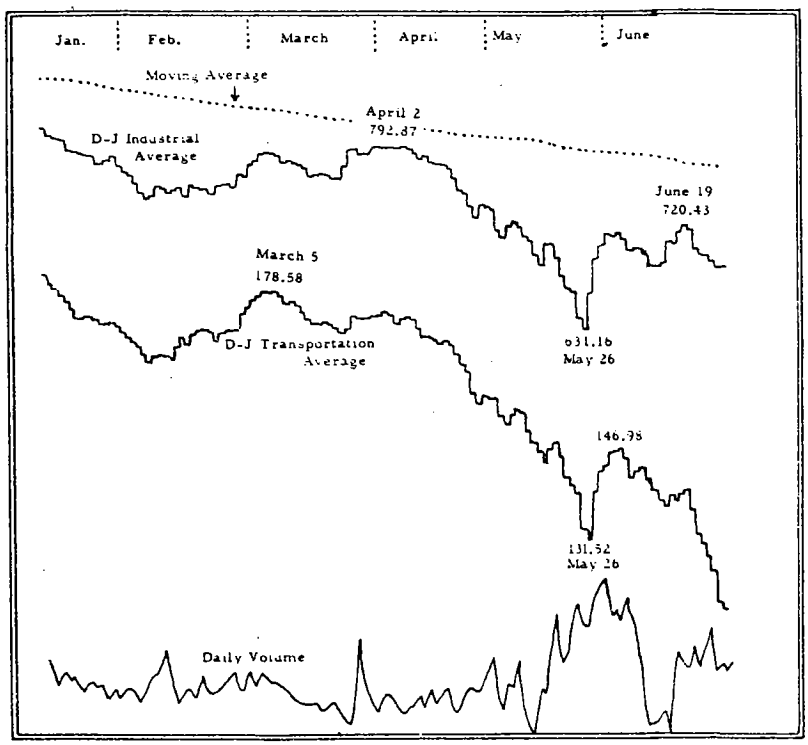
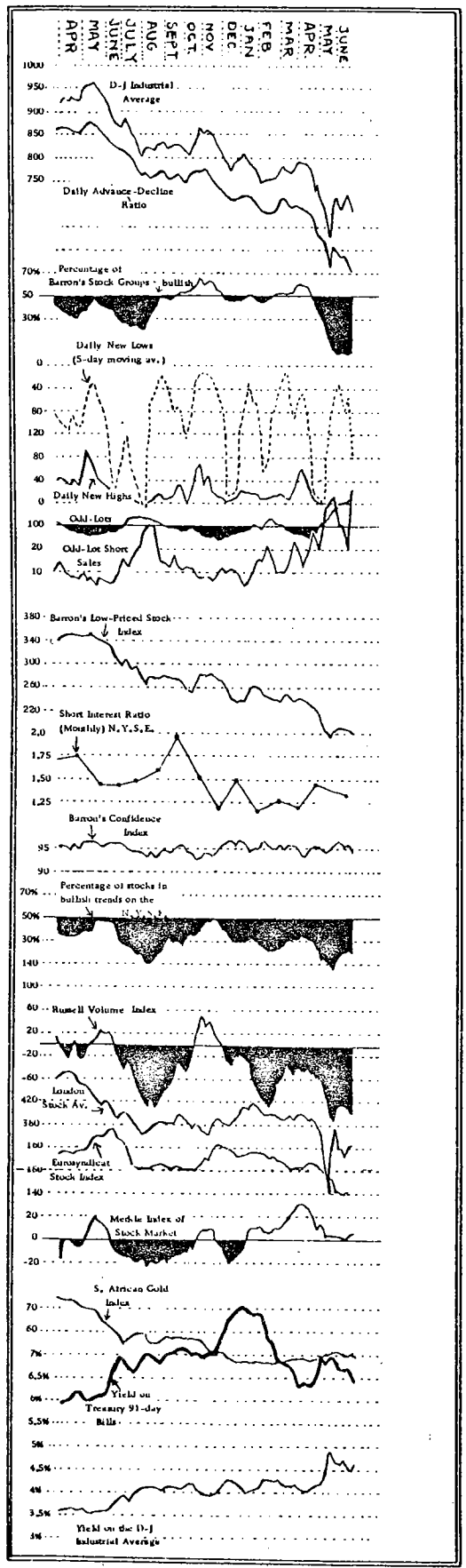
THE MARKET: I have stated in previous Letters that the primary trend exerts its force on literally all segments of the markets and the economy. In a great primary bear market, such as the one we are now witnessing, the direction of almost all indices (whether they are production indexes, price indexes or stock or bond averages) is down. I have also mentioned that there are five market indexes which I watch with extreme care, as each of these is outstandingly sensitive to the primary trend. These are the D-J Industrial, Transportation and Utility Averages, the daily advance-decline ratio and the 40-Bond Average.

On Friday, June 26, the D-J Transportation Average closed at 126.75, a new low for the bear market and the lowest level since 1962. On the same day the Utility Average closed at 96.59, a low for the bear market and the lowest level since 1960. The advance-decline ratio on June 26 broke to a new bear market low and the lowest level since 1945. The 40-Bond Average on June 26 closed at 66.34, lowest level since 1932. Only one index failed to confirm on the downside, the D-J Industrial Average.

Referring to the chart on this page, it is immediately obvious that there are two points of significance under the Industrial Average, the 684.21 low of June 12, and the extreme bear market low (established May 26) of 631.16. On Monday, June 29, the Industrial Average provided its first sign of important weakness by plunging below the 684.21 level. This leaves the Industrial Average in the crucial role of confirming the broad weakness of the other indices, or perhaps resisting by refusing to confirm.

At this time I want to mention something which I see occurring on all sides. There are a good many sincere young men in this business writing advisory reports. Some of the reports are excellent, many of them are not. But over and over again I note that these advisors have succumbed to the urge to be "a




D-J Industrial Average
Daily Advance-Decline Ratio
Percentage of Barron's Stock Groups bullish
Daily New Lows (5-day moving av.)
Daily New Highs
Odd-Lot
Odd-Lot Short Sales
Barron's Low-Priced Stock Index
Short Interest Ratio (Monthly) N.Y.S.E.
Barron's Confidence Index
Percentage of stocks in bullish trends on the
Russell Volume Index
London Stock Av.
Eurosyndicat Stock Index
Media Index of Stock Market
S. African Gold Index
Yield on Treasury 91-day Bills
Yield on the D-J Industrial Average

genius" and call the shots down to the last decimal. This, of course, is absurd. It simply can't be done, it never has been done and never will be done. Robert Rhea, who was in my opinion, the greatest interpreter of the Averages of all time, was just that — an interpreter, not a crystal ball gazer. Rhea believed (as do all real Dow Theorists) that the Averages tell the story, and that "everything" is built into the movement of the Averages. Anyone who had the ability to "read" the Averages perfectly would be able to correctly forecast all movements. Unfortunately, there never was such a man, although many men I have known have been awfully good.

Now, it's one thing to say that a major bear market is on, and that there is little or nothing at present to suggest that a bear market bottom has arrived or is even near arriving. It is another thing to say that "the Dow will nowdrop 200 points, touching its low on September 14." The latter statement is idiotic on the face of it, and only those who have not received their market baptism of fire would dare make such a pronouncement. Therefore, I am often impressed by the intelligence of those who say that the "market will do this or that by September 14," but I also know that they are on the road to obscurity. The market seldom does what some particular soothsayer wants it to do — and if it does for a while, it will not do it for long.

It is true that I use many technical indicators in an attempt to perhaps "get a jump" on the next possible direction of the Dow. I may use the Dow short interest ratio, a divergence between price and breadth, the odd-lot ratios or a few dozen other indicators. But these are all utilized in an attempt to improve my batting average. The final word is spoken by the Averages themselves, and I have too often seen the Averages do things that 80% of my other indicators said they "should not do." So much for the lecture.

From the standpoint of the near-time market trend, we are at one of those "why guess?" interludes. The Transportation Average has decisively plunged below its May low of 131.53 (see chart on page 1). The Industrial Average has not yet confirmed. A downside confirmation would require an Industrial drop below its comparable May low of 631.16. On the other hand, in order for the secondary trend to turn bullish it will be necessary for both Dow components to better their June peaks, Industrials at 720.43, Transportation at 146.98.

Technically, the only positive indications I see are the heavy odd-lot short sales and the obvious fact that Industrials have so far refused to confirm the dismal performance of the Transportation Average. On the negative side, the Transportation Average and decline ratio have plunged to such impressive new bear market lows that only the most persistent and powerful upside action could take them above their June highs (at which points they could confirm a possible new Industrial high).

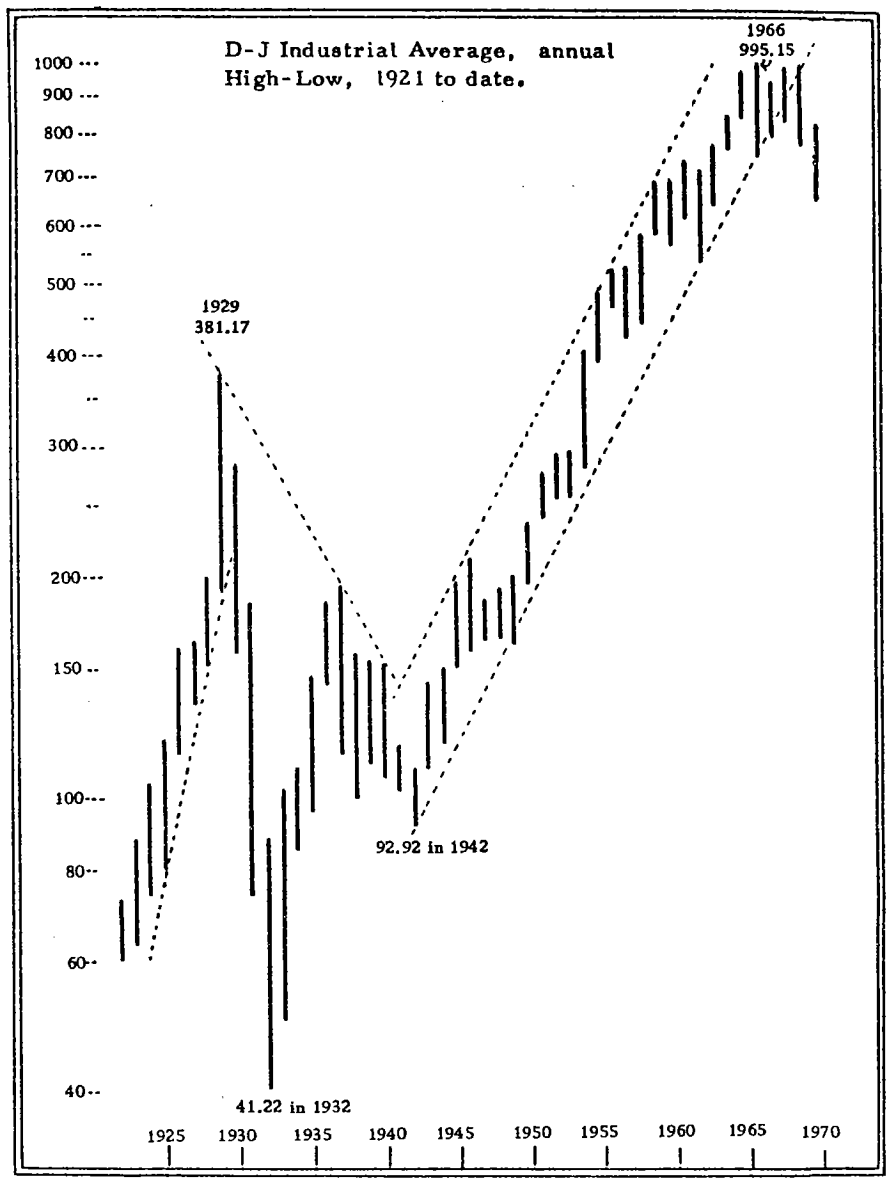
The latest short interest ratio figure for the 30 Dow Industrial stocks is .67, a very low and bearish figure and one hardly associated with strength (most major rises have begun with the Dow short interest ratio at 2.0 or more — see Letter 461). The "20 most-active stocks" index (see Letter 459) has put on a very unimpressive performance. After rising to a sub-standard peak of plus 7 on the week ending June 12, it plunged last week (week ending June 26) to minus 18. Thus, of the 13 weeks in second quarter 1970, 11 of them have seen the most-active index on the minus side. This would seem to indicate continuous distribution.

THE TIDE: Despite the fact that four of the five indicators previously mentioned have recorded new bear market lows, the majority of commentators continually fail to grasp the full meaning of the primary trend. Day after day, week after week, people scrutinize the headlines for signs to indicate that the decline is over and that "all is well on the Wall Street front." I have been writing about, and warning against, this attitude ever since the bear market began. The primary trend of the market is the strongest possible force that can be exerted on stocks. The primary trend does not reverse on a news event, a Presidential edict, a Federal Reserve Board decision or a Congressional uproar. The primary trend, although it may be subject to countless interruptions, continues to remain in force until it ultimately "dies" in exhaustion. This exhaustion in a bull market is the point where the market has discounted the best that can be seen ahead. In a bear market the exhaustion point is the level at which the market has discounted the worst that can be seen ahead.

During great primary movements, certain phenomena at the exhaustion points are almost always apparent. During a bull market top the phenomena consist of high volume, low yields on stocks, absurd prices on low-priced speculative issues, intense public participation, wide newspaper and magazine coverage of Wall Street. Signs of a bear market bottom during the third or final phase consist of low volume (perhaps 10% to 20% of that which existed at the top), high average yields on stocks, great pessimism regarding the economy, a collapse in many issues including the speculative leaders of the preceding bull market, disgust with Wall Street, and a general attitude which can best be described by the phrase, "There'll never be another real bull market while I'm alive."

Each new bull market stands on its own, bearing no relationship to any previous market movement. Thus a new bull market may exceed in advancing the Averages 50% or 500%. But a primary bear market does provide one advantage. It relates directly to preceding bull market. Thus, it is helpful to note that the longer the bull market, generally the longer the bear market. The greater the speculative edifice of the bull market, generally the more severe the ensuing bear market.

I am including this annual high-low chart of the D-J Industrial Average to be studied in the light of what I have written previously. Here we see the yearly high and low range of the Dow from 1922 to the present. I am going to use the word "probable" to describe what we may now expect. The Dow, since the 1942 low closing of 92.92, has been in a rising channel 25 consecutive years. This represents the longest such trend in the history of the N.Y.S.E. Now in order for such a trend to remain intact for 25 years (in other words, uncorrected in any major sense), a great many excesses have had to build into the economy. Not only were they built into the economy, they were built into the psychology of investors. People became absolutely certain that inflation was a permanent way of life, and they become obsessed with the idea of owning property, equities and debt as a means of beating inflation. Debt as a vehicle of control, became the fashion of the day. "If you're smart, you'll owe everybody lots of money," said the wise boys, "and if you ever pay off at all, you'll pay off with depreciated dollars." Margin accounts grew, debit loans grew, mortgages grew, the debt became a monster.



And then the barometer of the money markets rose. Interest rates rose to the highest level in 100 years, and suddenly those with debt were looking at the wall. And the wall was "service your debt or else....." and on top of the wall were the twin spectors of sliding sales and declining profits. How do you service your debts when your sales are sliding and your profits are dwindling? The harsh fact is that there is no law that says that everything has to work out fine. There's no rule that states that things "will just work out the way they always have."

And the market sees that. I felt that it saw it at the 1966 top, and it saw it even more clearly during 1969 when (see chart) the Dow fell out of its 25-year rising channel. And during 1970 the Dow began preparing in earnest for trouble as, for the first time in a quarter of a century, the high range of the Dow was far, far away from the lower channel limits.

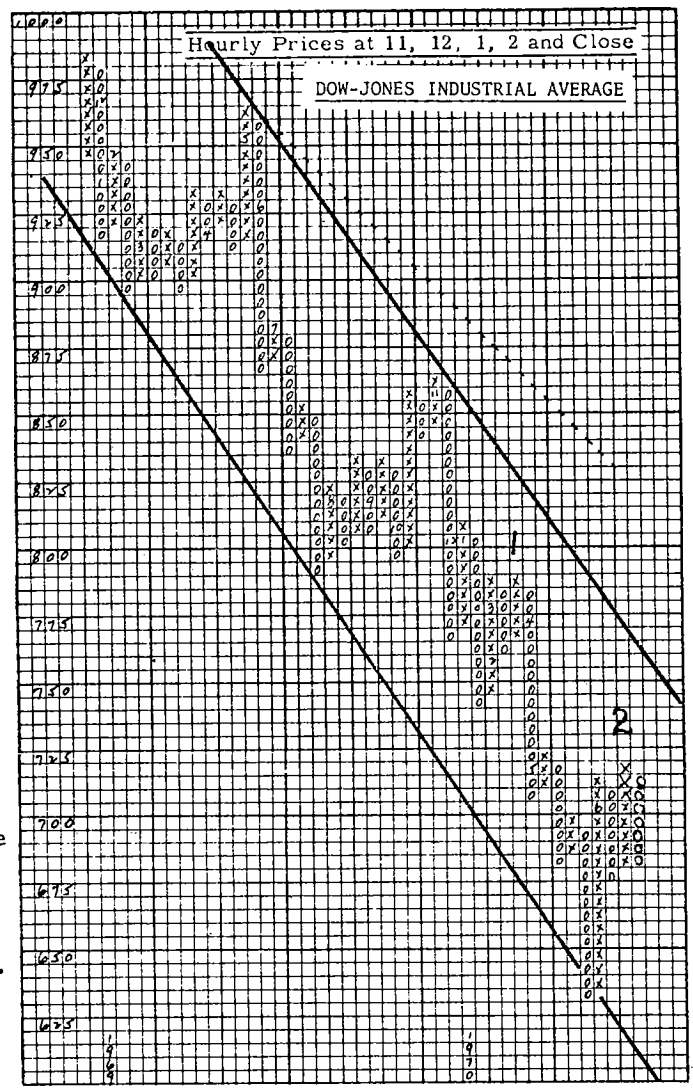
Now, as I look at the 4.5% yield on the Dow, the 8% to 11% yield on bonds, the still-present speculation, the mountainous debt problems, the GNP and sales indices essentially at their highs, the still firmly-entrenched optimism of businessmen and consumers, the spikes of volume during market rallies, I realize that nothing yet has been fully corrected, nothing at all has been solved. Those who are looking for the termination of the bear market in this area are, in my opinion, whistling in the dark. They are still thinking in terms of 1960 or 1962. And that is why I keep pounding these thoughts home to my subscribers. We've all stayed out of the bear market during this long-period of massive collapse. But to win, it's necessary to see the problem to conclusion. And the conclusion is not yet here. I'm reasonably certain of that.

TRENDLINES: One of the great mysteries of the price movements is why stocks and the averages tend to travel along trendlines. No one, to my knowledge, has ever offered a satisfactory explanation of this remarkable phenomenon.

Many of the uncanny mysteries of nature have never been explained or deciphered, yet scientists have used their observations and studies of these phenomena, often to great effect. By the same token, I have found that even though many technical

mysteries of the market cannot be explained, it is also a fact that they can be studied and important implications drawn.

Here is an example. The accompanying chart is a five-point, 15-point reversal, point & figure chart of the Dow Industrials. Each square on the chart equals five points on the Dow, and only rallies and declines of 15 points or more are shown. The X's on the chart represent rallies, the O's on the chart denote declines. (Chart courtesy of Chartcraft, Larchmont, N.Y.).



The high point on the chart (upper left) shows the 985.21 peak of December, 1968. From that point, all succeeding rallies and declines moved within well-defined declining channel lines as drawn on the chart. Now anytime the price movement travels within the confines of a declining channel, it may be stated that the near-term trend is down. Any rally within the channel can conceivably be the beginning of a reversal to the upside, but proof of a full reversal cannot come until the upper limits of the channel are decisively penetrated. So far, all recent rallies have halted at or below the upper channel limits, and this means that the bearish channel is still fully intact.

A second property of the price movement within a channel is that normally rallies tend to touch the upper channel limits while declines tend to touch the lower channel limits. A decline which fails to touch the lower channel limits often indicates the early beginning of strength. Conversely, a rally which fails to touch the upper limits of the channel usually indicates the beginning of, or at least the possibility of, outstanding weakness.

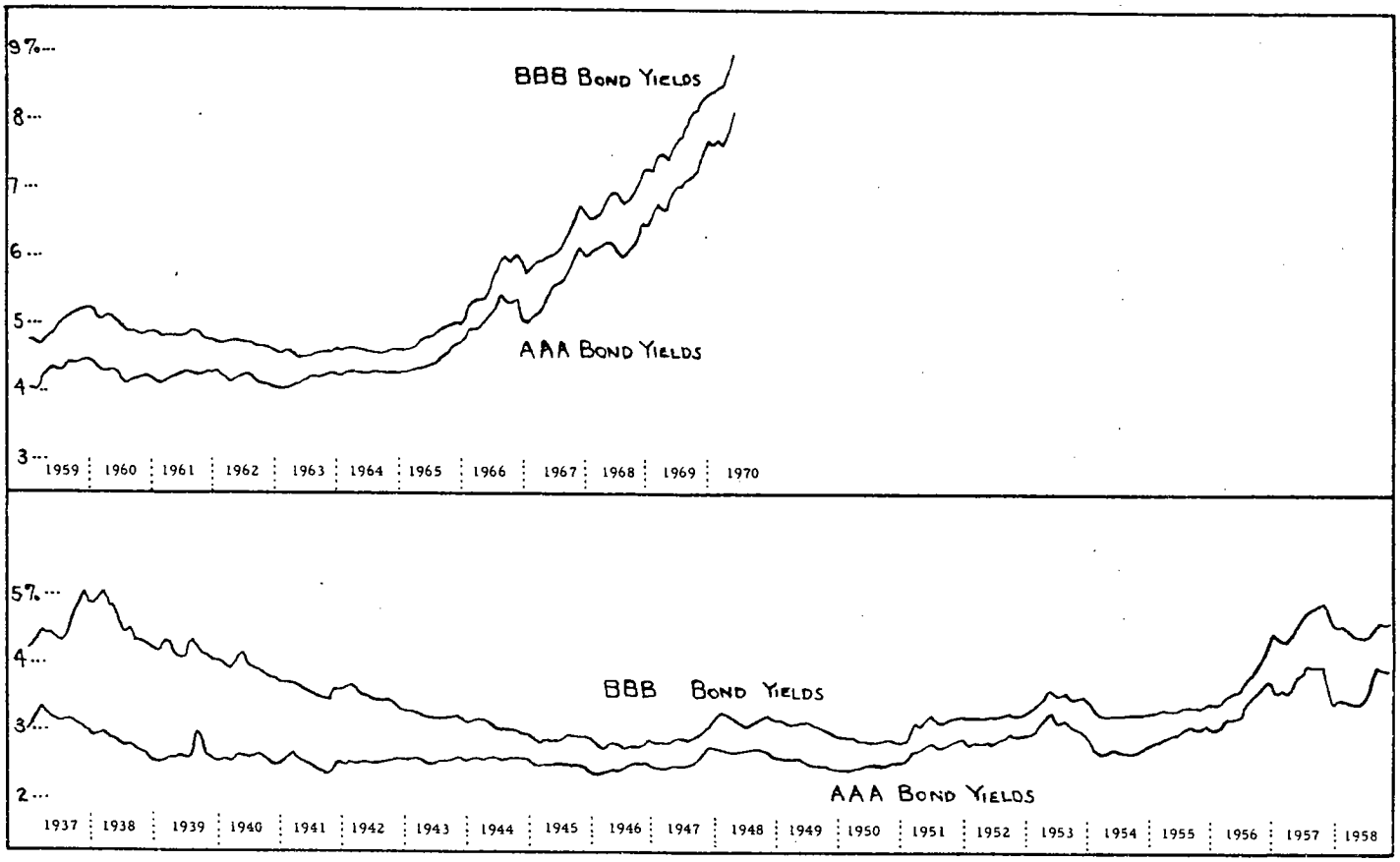
At the March, 1970 peak of 792.37 (marked 1 on chart) the Dow failed to touch the upper channel limits. This technical failure was followed by a 161 point drop to the May 26 low of 631.16. Note that at the May low the lower limit of the channel was slightly penetrated. From here the explosive May-June rally took the Dow to a June 19 closing of 720.43 (2 on chart). This was even farther below the upper limits of the channel than was the earlier March, 1970 peak.

Of course it is too early to term the latest rally a "failure", since it is possible that a new rally will take the Dow up to the upper channel limits again. As far as point & figure is concerned, the level to watch now is 675 on the downside. If the Dow touches 675 on an hourly or closing basis, it will have dropped below the last row of O's, thus rendering a definite "sell signal". On the other hand, any rally to 725 will have bettered the last row of X's, thus providing a bullish indication (note that I do not use the term "buy signal" during a primary bear market).

CONFIDENCE: Barron's Confidence Index is the ratio of the yields of high-grade bonds to medium-grade bonds. In times of financial crisis, investors move out of medium-grade bonds (even though they have higher yields) towards the lower-yielding but safer high-grade bonds. When this occurs the Confidence Index goes down. The reverse is true during periods of boom and great optimism, at which time investors foresake safer but lower yielding top-grade bonds for the higher yields of the medium-grade bonds.

All very well. But currently, bond yields on all classifications of bonds are at record highs. Thus, there is less and less movement in the Confidence Index, since the higher the yields the less action in the ratio. For instance there is much more of a ratio spread between 3% and 4% than there is between 9% and 10% although there is a 1% spread between each series.

The accompanying chart (page 5) shows a good deal more than the standard Confidence Index at this time. It is a chart showing the yield of Standard & Poor's AAA-rated Industrial Bond Average and the yield on S & P's BBB Industrial Bonds. The chart goes back as far as S & P's figures, to 1937, and I think what these yield patterns show is interesting.



During late 1937 and early 1938 the spread between the AAA's and the BBB's was about 210 basis points (2.10%). Thus, in that time of crisis and financial collapse the BBB's were bringing a premium of better than 2% over the AAA's bonds. Confidence increased steadily until by 1946 the yield gap had closed to 25 basis points. In other words, by 1946 there was very little difference in the yields of BBB bonds over AAA bonds.

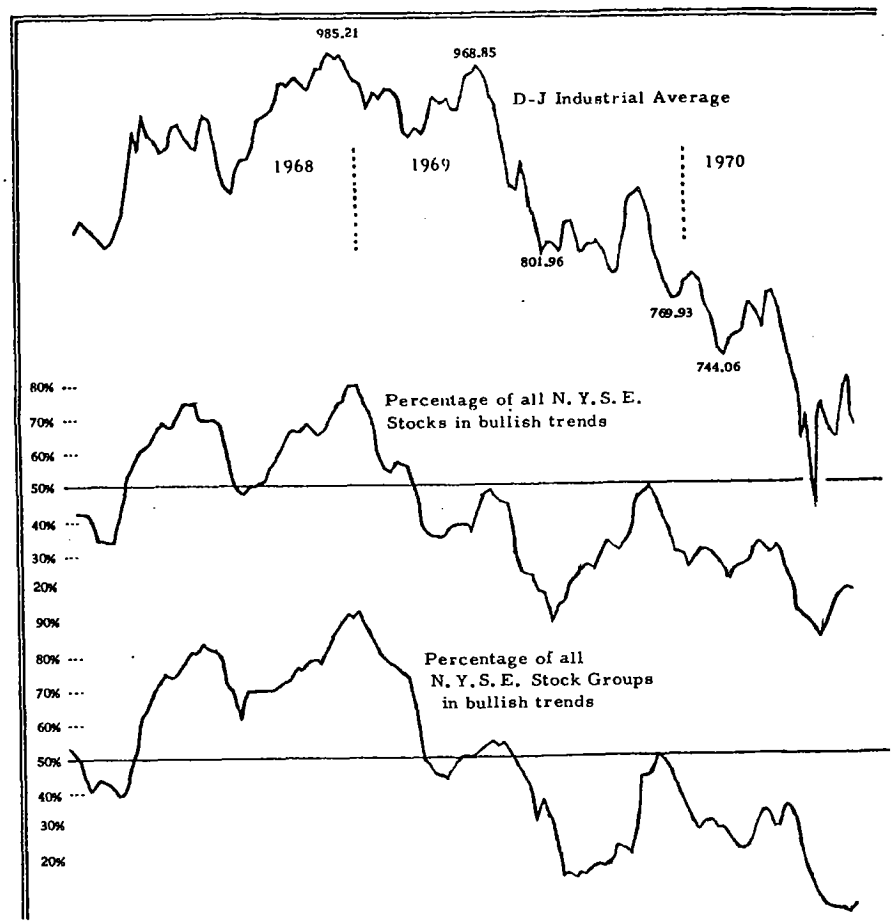
The next big yield spread (although it was nothing like 1937-38) came in early 1958, when a severe recession moved the yield spread to slightly more than 100 points. From then on, the yield spread stayed narrow, and by early 1966 the spread was an incredibly small 30 points, indicating very high confidence on the part of bond-buyers. By late 1966, with the money crunch in full force, the yield spread widened to over 80 basis points, a big increase over early-1966 but hardly a figure representing any great loss of confidence.

Now the extraordinary fact is that since 1966 the yield spread has not widened appreciably. The current spread of about 80 points hardly indicates any great worry on the part of bond buyers. In fact, the current spread is less than that which existed during 1957-58, and less than half than that which appeared during 1937-38. I find this a very significant fact. It means to me that despite the Lockheed and Penn Central and I.O.S. troubles, today's bond buyers maintain a fantastic degree of confidence in the solvency of the bond markets.

Are they correct? Only time will tell, but my feeling is this: I believe that today's bond buyers are viewing the whole liquidity situation through rose-colored glasses. I feel that the yield spreads are indicating that the bond buyers are not taking the liquidity crisis seriously, and that somewhere in the back of their heads they are thinking that "everything is all right," or that "the Government will not let anything really serious happen."

Or to take the other side of the coin, I would say that the yield spread is now worth watching very carefully. Anything above 150 basis points would indicate a great loss of confidence and anything near 200 points would indicate near panic conditions in the bond markets.

STOCKS: My percentage of all stocks on the N.Y.S.E. in bullish trends is currently around 17%, up from an extreme low of 7%. The percentage of all groups on the N.Y.S.E. in bullish trends is 4.7%, still at an extreme low. These figures (from



hartcraft's weekly tabulations) are shown charted on this page. The trend of these figures is significant, and normally if both stocks and groups move above the critical 50% level (which they have not done since 1968) we can say that at least an important secondary reaction is underway. As of this writing, nothing of a bullish nature can be deduced.

The manner in which stocks are distributed (and accumulated) is always interesting. The high-grade stocks, usually owned by the more knowledgeable segment, generally form true distribution patterns and these patterns take time. As seen on the charts of Woolworth, IBM and Burroughs, the patterns usually produce a "rounding over" effect as sellers pass the blue-chips to weaker buyers and the stocks gradually lose upside momentum, then slowly gain downside momentum. (Charts courtesy of Quote Digest, 403 N. Main, Wichita, Kansas).

The story in the speculative issues is not as pleasant. Classically, the "cats and dogs" run up to a speculative spiked peak, then plunge as everybody runs at once. There is little or no support on the way down, the stocks have little following once they p out, and the losses piled up are overwhelming. his action can be seen in the charts of Jervis, Filmways and Curtis Mathes all on the Amex.